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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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| In the Matter of | ) | |
| | ) | |
| Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992 | ) ) ) ) | MM Docket No. 93-215 |

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FEDERAL COMMUNICATIONS COMMISSION
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# COMMENTS OF GTE

GTE Service Corporation and
its affiliated domestic
telephone operating companies

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## SUMMARY

GTE congratulates the Commission on its segmentation of the ratemaking requirements for cable operators into benchmark initial rates, prices for any increases and cost-of-service as a safeguard for rates too low to earn reasonable return. The Commission recognized that rules may require refinement and improvement as it reviews and monitors the effect of its initial rate regulations. Its Congressional mandate permits wide discretion in cable regulation and the benchmarks/price caps model fits soundly within this regulation. GTE has presented evidence of the convergence of the telephone and cable industries, including the August 24, 1993 decision by the United States District Court finding that the video programming ban on LECs to be unconstitutional. Recognition of this convergence will give the Commission a unique opportunity to regulate the entire telecommunications industry using a fresh start.

GTE's Comments focus on the refinement of the price cap mechanism and selection of a suitable price cap formula. Responding to the Commission's invitation for expert economic analysis on the issue of productivity, GTE offers the statement of Dr. Mark Schankerman of the London School of Economics. Dr. Schankerman notes that price caps require selection of suitable yardsticks for input prices and productivity to ensure both reasonable compensation and efficient behavior. To meet these requirements. Dr. Schankerman proposes that price changes permitted regulated cable systems be capped by price changes made by systems subject to effective competition. This eliminates the need to determine a productivity offset for the cable industry, meets the objective of regulatory simplification, and can easily be implemented. If, however, the Commission retains its provisional price cap the productivity offset (the x-factor) should be equal to the LEC x-factor, currently 3.3 percent, until hard evidence on cable TFP is available and evaluated.

While GTE urges the Commission to rely on the benchmark/price cap model, cost-of-service elements must be identified to define cost-of-service. GTE offers specific cost-of-service element comments on the tentative conclusions regarding depreciation, cost allocation, and the process for determining rate of return.

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## COMMENTS OF GTE

GTE Service Corporation and its affiliated domestic telephone companies ("GTE") offer their comments in response to the Commission's release on July 16, 1993 of its Notice of Proposed Rulemaking ("NPRM") captioned above.

### I. The Commission Must Use Its Permitted Discretion to Devise a Scheme of Regulation Which Will Accommodate the Realities of the Converging Telephone and Cable Industries.

GTE congratulates the Commission on its segmentation of the rate making requirements for cable operators into a benchmark initial rate, price caps for any increases and cost-of-service as the safeguard for those operators who would otherwise be injured by rate levels too low to earn a reasonable return.[1] Such a balanced approach meets the Congressional mandate to provide a method of determining cable rates without an excessive burden on either the regulatory agency or the cable operator.[2]

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1 Implementation of the Cable Television Consumer Protection and Competition Act of 1992 - Rate Regulation, MM Docket No. 92-266, Report and Order and Further Notice of Proposed Rulemaking, FCC 93-177 (released May 3, 1993), 1993 FCC LEXIS 2417, *review pending sub nom. Columbia Associates, L.P. v. FCC*, No. 93-1409 (D.C. Cir., June 22, 1993) ("*Rate Regulation Order*").

2 Conference Report, Rep. No. 102-862, 102d Cong., 2d Sess. at 62 ("Conference Report").

However, as the Commission recognized, this must be an ongoing process with the rules changing as the Commission "review[s] and monitor[s] the effect of [its] initial rate regulations . . . and refine[s] and improve[s] [its] rules as necessary."[3] GTE's comments focus on refining the price cap mechanism by which future changes in initial cable service rates will be governed. Responding to the Commission's invitation for expert economic analysis,[4] we are appending the statement of Dr. Mark Schankerman of the London School of Economics. Dr. Schankerman notes that price caps require "selection of a suitable yardstick for input prices" and productivity to ensure both reasonable compensation and efficient behavior.[5] To meet these requirements Dr. Schankerman proposes that price changes permitted regulated cable systems be capped by price changes made by systems subject to effective competition. He also calls for refinement of the benchmark factors by which initial rates are to be set because:

> If the benchmark procedure is crude, cable operators will be far more likely to apply for relief under cost of service procedures which would destroy both efficiency incentives and administrative simplicity.[6]

Where cost-of-service showings are required as a backstop to benchmark/price cap methods, GTE urges the Commission to pay particular attention to depreciation, cost allocation and rate of return elements -- recognizing the convergence of telephone and cable companies.

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3 Rate Regulation Order at paragraph 10.

4 NPRM at paragraph 85.

5 Dr. Mark Schankerman, Benchmarks and Yardsticks for Cable Regulation at 6-7 ("Attachment").

6 *Id.* at 7.

### A. The Congressional mandate permits wide discretion in cable regulation.

Congress expressly stated its policy to be carried out by the Commission is that "where cable television systems are not subject to effective competition, ensure that consumer interests are protected in receipt of cable service. . . ."[7] This statement of policy originated in the Senate[8] which gave the Commission "broad discretion" in the ratemaking arena, permitting it to "only deal with individual systems when special circumstances exist."[9] Included within that discretion is the ability to refrain from regulation which too closely monitors the cable operators' investment, technology and programming choices, and introduction of new services. Use of initial benchmark rates and an ongoing price caps scheme is well within the Commission's statutory mandate.

If regulation is to complement competition, the application of price caps must place the risk of failure on shareholders, not customers. Cost-of-service as a safeguard should be triggered only in the event that a system has a history of low earnings and can be presumed in need of a rate increase only to assure that its situation does not deteriorate to the point of no return from the standpoint of investors. GTE will discuss this concept in more detail.

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7 Cable Television Consumer Protection and Competition Act, Pub. L. No. 102-385, Section 2(b)(4), 106 Stat. 1460 (1992) ("1992 Cable Act").

8 Conference Report, at 58.

9 Senate Committee on Commerce, Science, and Transportation, S. R. No. 102-92, 102d Cong. 1st Sess. at 72 ("Senate Report"). One special circumstance which requires Commission attention to individual systems arises when there is an allegation that the system's present rates are not sufficient to meet the constitutional tests embodied in the *Duquesne Light Co. v. Barasch*, 109 S.Ct. 609 (1989), *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), and *Bluefield Water Works & Improvement Co. v. Public Service Comm'n of the State of West Virginia*, 262 U.S. 679 (1923) decisions.

The Commission has concluded that it may incorporate regulatory tools used for Title II regulation, such as price caps, in its rate regulatory design for cable rate regulation.[10] Numerous cable commenters, in MM Docket 92-266, have resisted this approach which introduces regulatory parity between Local Exchange Carriers ("LECs") and cable operators.[11] More specifically, they have objected to the application of price caps to cable regulation, based on Section 621(c) of the 1984 Cable Act, which states that:

> Any cable system shall not be subject to regulation as a common carrier or utility by reason of providing any cable service.[12]

The cable commenters have stretched this provision to apply in a way Congress could never have intended, arguing that the plain language of the section compels the conclusion that regulatory parity is prohibited. GTE submits that the argument is incorrect, and agrees that the Commission has the authority to incorporate price caps into the regulatory scheme. In any case, the D.C. Circuit has held:

> [A] court can look beyond the plain meaning of a statute in limited instances, most notably when there is an assertion of a significant change in circumstances since enactment, *see Perry v. Commerce Loan Co.*, 383 U.S. 392, 397-400, 86 S.Ct. 852, 15 L.Ed.2d 287 (1966), or when a literal reading leads to an unreasonable result, *see United States v. American Trucking Associations*, 310 U.S. at 543, 60 S.Ct. 1059.[13]

Both situations are present here.

Section 621(c) was adopted in the context of a general exemption of cable television service from rate regulation. As such, its meaning must be determined within

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[10] NPRM at paragraph 15 n.16.

[11] Replies to Oppositions to Petitions for Reconsideration of Discovery Communications, Inc. at 5, Liberty Media at 2-3, Time Warner Entertainment at 2-4.

[12] Cable Communications Policy Act of 1984, Pub. L. No. 98-549, 98 Stat. 2779 (codified as amended at 47 U.S.C.A. Section 541(c)) ("1984 Cable Act").

[13] *Consumers Union of U.S., Inc. v. Heimann*, 589 F.2d 531, 534 (D.C.Cir. 1978).

that context.[14] Similarly, although its text was unchanged by the 1992 Cable Act, it must nevertheless be construed in a manner consistent with the 1992 Cable Act's overall re-regulatory intent.[15]

The cable commenters argue that price caps and other LEC-type regulations are prohibited by Section 621(c). Adherence to this position would prevent the utilization of any form of regulation that may also be imposed upon a telephone company, regardless of the benefits. Clearly Congress did not intend to deprive the Commission of valuable regulatory tools simply because they have been effective in the regulation of telephone companies.

The position of the cable commenters is based on the erroneous assumption that all forms of telephone regulation are encompassed in the earlier proscription of common carrier regulation. In enacting Section 621(c), Congress explained that a "cable system would not . . . be subject to *rate of return regulation*, or to the traditional common carrier requirement of *servicing all customers indifferently* upon request . . . to the extent that the cable system is providing cable services."[16] These were two hallmarks of LEC regulation in 1984 that were also traditionally associated with common carriage.

LEC regulation, however, has evolved in ways unforeseen in 1984. The substitution of price caps for rate of return regulation is one of the most notable

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[14] *See Callejas v. McMahon*, 750 F.2d 729, 731 (9th Cir. 1985) (It is the duty of a court in construing a statute to consider time and circumstances surrounding the enactment as well as the object to be accomplished by it.).

[15] *U.S. v. Morton*, 467 U.S. 822, 828 (1984) (We do not, however, construe statutory phrases in isolation; we read statutes as a whole.); *United Mine Workers of America v. Andrus*, 581 F.2d 888, 892 (D.C. Cir. 1978) (Statutory provisions are to be construed, however, not in isolation but together with other related provisions.).

[16] H.R. Rep. No. 98-549, 98th Cong., 2d Sess. at 60, *reprinted in* 1984 U.S.C.C. & Ad. News 4655, 4697.(emphasis added)

differences. Price caps was deemed by the Commission to be a significant change from conventional common carriage rate of return regulation.[17] Congress cannot be held, by Section 621(c), to have passed judgment on these changes that occurred after 1984.

In the 1992 Cable Act, Congress sought to rein in the monopoly pricing that had become so prevalent in the cable industry absent effective competition. Congress imposed a multitude of statutory restraints and requirements, leaving much of the detail to the Commission. Many of these statutory provisions themselves resemble traditional common carrier regulation.[18] It is in this re-regulatory context that Section 621(c) must now be construed.

The only way to read Section 621(c) consistently with the changes in the 1992 Act is to restrict its application to the context of the 1984 regulatory environment in which it was enacted. Under this construction, Section 621(c) prohibits the imposition upon cable systems of traditional common carrier obligations, *i.e.,* holding out services

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[17] *Policy and Rules Concerning Rates for Dominant Carriers*, Report and Order and Second Further Notice of Proposed Rulemaking, CC Docket No. 87-313, 4 FCC Rcd 2873 (1989).

[18] For example, the new rate regulation language of Section 623, 47 U.S.C. Section 543, contains Title II concepts and terms such as "reasonableness" and "joint and common costs." Similarly, the FCC's added authority, under Section 612(c), 47 U.S.C. Section 532(c), to set maximum rates and establish reasonable terms and conditions for commercial leased access by non-affiliated lessees, reinforces the law's allowance of telephone-like regulation. As a matter of statutory construction, the Commission can and must read these additions as reconcilable with Section 621(c).

indifferently. It does not prohibit the Commission from borrowing other forms of regulation from its LEC experience and applying them to cable systems.[19]

### B. The Commission has a unique opportunity to regulate using a fresh start.

No commenter on today's telecommunications industry sees anything except expansion and integration of telephony, both wireline and wireless, cable and other broadband video delivery, and computers into an information highway for both residential and business use. Portions of the industry are still highly regulated, other

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[19] The Commission's premise in this cost-of-service docket, long established in utility law, is that cable operators must be permitted "to recover the reasonable costs of providing cable service and to attract capital. . . ." NPRM at paragraph 8. To this extent, cost-of-service regulation is a "backstop," NPRM at paragraph 7, benefiting cable operators, who presumably will not protest that such consideration violates Section 621(c).

portions lightly regulated, and many emerging sectors have no regulation.[20] Regulation of cable rates must be viewed as a fresh start in balancing need for regulation with the demands of the marketplace.

As the telecommunications industry moves into a more competitive era, it is paramount that regulators relinquish their detailed oversight with respect to utility operations. Cable operators, LECs, and other providers such as Cellular Carriers must be permitted to exercise their informed business judgment, particularly in the area of competitive services. The emergence of competition creates an environment in which regulation must be refocused on overall price constraints, which the Commission has recognized. If the system of price caps regulations and the pricing flexibility originally contemplated for LECs is to be continued and expanded to include cable operations

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20 The Commission recognized the necessity to mark a line between regulated common carriage and unregulated equipment/computer services in its long journey toward the definition of basic and enhanced services. See, Regulatory and Policy Problems Presented by the Interdependence of Computer and Communications Services and Facilities (Computer Inquiry), 28 F.C.C.2d 267 (1971), *recon. denied,* 34 F.C.C.2d 557 (1972), *aff'd in part and modified in part sub nom. GTE Service Corp. v. FCC,* 474 F.2d 724 (1973); Second Computer Inquiry, Docket 20828, Final Decision, 77 F.C.C.2d 384 (1980), *reconsideration,* 84 F.C.C.2d 50, 72-5 (1980), *further reconsideration,* 88 F.C.C.2d 512 (1981), *aff'd sub nom. Computer and Communications Industry Ass'n v. FCC,* 693 F.2d 198 (D.C. Cir. 1982), *cert. denied,* 461 U.S. 938 (1983), *further recon. denied,* FCC 84-190 released May 4, 1984; Amendment of Section 64.702, CC Docket No. 85-229, Phase I, Report and Order, 104 F.C.C.2d 958 (1986) ("Phase I Order"), *reconsideration,* 2 FCC Rcd 3035 (1987) ("Phase I Reconsideration Order"), further reconsideration, 3 FCC Rcd 1135 (1988) ("Phase I Further Reconsideration Order"), *second further reconsideration,* 4 FCC Rcd 5927 (1989) ("Phase I Second Further Reconsideration Order"), Phase I Order and Phase I Reconsideration Order *vacated sub nom. California v. FCC,* 905 F.2d 1217 (9th Cir. 1990); CC Docket No. 85-229, Phase II, 2 FCC Rcd 3072 (1987) ("Phase II Order"), *modified on reconsideration,* 3 FCC Rcd 1150 (1988) ("Phase II Reconsideration Order"), *further recon.,* 4 FCC Rcd 5927 (1989) ("Phase II Further Reconsideration Order"), Phase II Order *vacated sub nom. California v. FCC,* 905 F.2d 1217 (9th Cir. 1990), *pet. for review pending* of Phase II Order and Phase II Reconsideration Order *sub nom. BellSouth Corp. v. FCC* (9th Cir. No. 88-7290, filed April 20, 1988).

and function successfully, cable operators (and LECs) must be accorded the ability to set prices and structure services in accordance with market requirements. What the Commission does in this docket must be done with an eye on the horizon.

### C. The convergence of telephone and cable into telecommunications requires the Commission to view both industries at the horizon.

The months since the enactment of the 1992 Cable Act have borne out all the predictions made since the Commission's first decision regarding the convergence of the telephone and cable industries. Whether the announcement is by a cable company, a LEC, an equipment manufacturer, or Interexchange Carrier ("IXC"), the news is always the same -- broadband facilities will provide both cable and telephone over the same network.[21]

Tele-Communications, Inc. ("TCI") recently announced its intention to invest over two billion dollars in fiber upgrades of its local networks to provide broadband video and telephone services to its local customers.[22] Follow-up news stories indicate that TCI does not consider the Commission's *Rate Regulation Order* to be an impediment to its

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[21] This integration of services is all the more likely given the August 24, 1993 decision by the United States District Court finding the video programming ban on LECs to be unconstitutional. *C&P Telephone Company of Virginia v. United States*, Civil No. 92-1751-A (E.D. Va.).

[22] Matt Rothman, *TCI Unveils $2 Bil Fiber-optic Plan*, DAILY VARIETY, April 13, 1993, at 1. ("But the cable companies may end up in joint ventures with the telcos, or computer companies to bring many of the new services to customers. TCI is already experimenting with U.S. West in the Denver area and McCaw Cellular in Medford, Ore." *Id.*)

plans.[23] Southwestern Bell Corporation has announced the acquisition of Hauser Communications' cable systems in Montgomery County, Maryland, and Arlington County, Virginia, which serve 225,000 cable customers, evidencing its intention to enter the cable television business, and probably the local exchange business outside its own region.[24] Sun Microsystems announced it was entering discussions with Time Warner to provide the technology presently available in its computer work stations at the home TV.[25] Microsoft Inc. has made a product announcement that it has available a Windows operating system which can be installed in a telephone or television set to bring the capabilities of the computer to those devices.[26] A telecommunications technological revolution is underway.

Time Warner and U.S. West announced that the latter is investing $2.5 billion in Time Warner Entertainment, the cable television subsidiary of Time Warner for a 25

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23 Geoffrey Foisie, *Real Numbers on Rate Regulation*, BROADCASTING AND CABLE. July 26, 1993, at 6,7 (The MSO is planning to recapture lost revenue through aggressive marketing, including deeply discounted pay services. This is reflected by analysts projections of a ten percent growth in 1994 cash flow over 1992. Another MSO, Continental, recently filed a prospectus with the SEC in which it said it would more than double capital spending "to further expand channel capacity and to deploy addressable technology more extensively, including the utilization of digital technology in some systems." *Id.* at 7.)

24 John Lippman, *Baby Bell to Buy Cable TV System*, LOS ANGELES TIMES, February 10, 1993, at 1.

25 *Time Warner, Silicon Graphics Teaming on Interactive TV*, UPI, June 7, 1993, *available in* LEXIS, Nexis Library, UPI File; Ken Siegmann, *SGI Unveils Multimedia Workstation Silicon Graphics' New Indy Has a Video Camera, Advanced Sound*, THE SAN FRANCISCO CHRONICLE, July 12, 1993, at B1.

26 In a recent article, one commentator described the Microsoft vision as having "the potential to affect the most people" of all the announcements from the company over the last twelve months. He went on to explain that this would occur because "phones and fax machines and copiers touch the lives of many people who don't use personal computers at all." Berst, WINDOWS MAGAZINE, September 1993 at 43.

percent equity interest.[27] The two companies plan for the design, implementation and direction of full-service networks, "which will accommodate a wide range of services including video on demand and telephony."[28]

In addition to AT&T's recent announcement of its intent to purchase McCaw Communications, a move which squarely positions AT&T to enter the local exchange market,[29] AT&T has announced its participation with Viacom International Inc. in an interactive, two-way cable system trial involving at least 1000 homes in Castro Valley, California.[30] AT&T has also signaled its intent to "go into business with the cable industry, . . ." with value to be provided by cable "as an enabling technology," according to AT&T employee Richard Bodman.[31]

Only one conclusion can be drawn from this technological explosion. Capacity hitherto unknown now exists in the hands of the individual user to communicate, by voice, data, and image. Competition to put that capacity in the hands of the user is intense and there is no bottleneck available to any firm. What it all comes down to is an industry that can no longer be segmented based on what is carried today. The

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27 Rich Brown & Harry A. Jessell, *Telco-Cable Giants Converge: US West buys 25% of Time Warner, Furthering Companies' Plans for Full-Service Network*, BROADCASTING & CABLE, May 24, 1993, at 6

28 *Id.*

29 Kurt Eichenwald, *Wired for Wireless*, THE DALLAS MORNING NEWS, August 17, 1993 at D1.

30 *AT&T to Tap Into Interactive TV; Alliance Tests Video Servier, Games*, TELEPHONE WEEK, June 7, 1993, Vol. 10, No. 23. In the same week, AT&T announced a video server "to complement its GCNS-2000 ATM switch, which offers interactive broadband capabilities. . ." and with Sega "a low-cost communications platform that will make possible interactive game-playing over the public switched networks." *Id.*

31 Stem, *Cable Operators Look for Other Revenue Streams*, BROADCASTING & CABLE, Jul. 26, 1993, at 96.

Commission must consider this fact in setting the regulatory policies and direction for the nation. It is time to regulate the telecommunications industry as a whole.

In summary: The Commission has wide discretion to create a regulatory scheme for cable operators which will consider the convergence of the telecommunications industry.

## II. The Regulatory Scheme Must Be Considered As A Whole.

The *Rate Regulation Order* concluded that the primary method for regulating cable systems should be the benchmark and price cap approach,[32] while cost-of-service regulation would serve as a "backstop."[33] The NPRM requests comment on the detail and extent of rules to be adopted for cost-of-service showings to be submitted by cable operators that seek to justify rates above the benchmark/price cap rates.[34] The Commission also asks for comments on the need and magnitude of the productivity offset, laying out four specific options.[35] If cost-of-service based regulation is to be a "backstop", then review of the overall regulatory scheme and how each mode within the Commission's scheme must interact becomes the essential starting point.

GTE urges the Commission to refocus from the backstop to the price caps to assure that price caps properly reflect the competitive marketplace and, to a significant extent, make the backstop immaterial. Given this context, the selection of the proper price cap formula inclusive of appropriate incentives must be of major consideration. As will be shown, the specification of the cap will determine whether the regulatory

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32 NPRM at paragraph 4.

33 *Id.* at paragraph 7.

34 *Id.* at paragraph 1.

35 *Id.* at paragraph 85.

scheme will serve to reach the Commission's and the Congress' goals to protect consumers from unreasonable rates and promote efficiency, infrastructure development and new programming.[36] Proper definition of the price cap is critical to avoiding burdensome regulation and defaulting to reliance on the cost-of-service methodology. The importance of the price cap formula can easily be lost sight of in the midst of the many details of traditional cost based regulation.

The Commission has invited "expert economic analysis" of the issue of cable productivity for inclusion in the price cap mechanism.[37] The Attachment, the Statement of Dr. Mark Schankerman entitled *Benchmarks and Yardsticks for Cable Regulation* is offered by GTE for that analysis as well as to demonstrate the necessity to place cost-of-service in its proper perspective. Dr. Schankerman recommends that the Commission adopt an extremely simple cap that is based solely on the change in prices of competitive cable systems. This not only incorporates an appropriate productivity adjustment, it results in a cap superior to that provisionally adopted by the Commission in the *Rate Regulation Order.*

### A. Benchmark rates are key to establishment of a total scheme of regulation.

Given Congressional policy that competition is preferred to regulation in the cable industry, the Commission's conclusions in the *Rate Regulation Order* at paragraphs 205-207 that benchmark rates based on competitive systems are the preferred method to initiate cable regulation makes the remainder of the scheme dependent in large part on the accuracy of the benchmarks. As the Commission

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[36] *See,* 1992 Cable Act Section 2(b)(3) & (4) statement of policy on improving the infrastructure as well as providing for reasonable prices. The Commission's goals are stated in NPRM at paragraphs 7 through 14.

[37] NPRM at paragraph 85.

stated, "[b]enchmarks permit ready means of identifying systems with presumptively unreasonable rates, while at the same time defining a zone of reasonableness that can accommodate a range of existing rate levels below the benchmark."[38] The Commission also recognized that benchmarks could "protect consumers from excessive rates," and "keep the costs of administration and compliance low. . . ," as opposed to cost-of-service regulation.[39] Dr. Schankerman describes this as requiring benchmarks established based on "quality and completeness," coupled with severe limitations on the ability of a cable operator to initiate a cost-of-service review.[40]

Dr. Schankerman explains that proper benchmarking is necessary for price caps to produce its twin benefits of compensation of costs and incentives to achieve efficiency.[41] He finds that the Commission's initial benchmarks are provisionally sufficient, but suggests that to assure the proper framework, an expanded analysis of 1993 results be undertaken which considers additional cost causation factors.[42] He explains that it is important that the benchmark model be strengthened for the reason that there is a basic tradeoff in designing this regulatory framework of benchmarks and ongoing price caps between the quality and completeness of the benchmark model on

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[38] Rate Regulation Order at paragraph 185.

[39] *Id.*

[40] Attachment at 7.

[41] *Id.*

[42] Attachment at 15. A number of cable operators have filed petitions for reconsideration alleging that the Commission's initial benchmark prices are insufficient, and suggest that other measures be utilized. *See* Liberty Media Corporation at 13; Dow, Lohnes, and Albertson at 5, 10, 11; Time Warner Entertainment at 8; Century Communications Corp. at 2, 3. Dr. Schankerman does not suggest the initial benchmark prices are insufficient, he concludes that the initial benchmarks be used for a one-year period pending completion of the expanded analysis. Attachment at 8.

the one hand, and the reliance on cost-of-service appeals on the other. His recommendation is that the Commission pursue the regulatory policy of benchmarks/price caps it has initially determined.[43]

**B. Price caps should become the accepted ongoing methodology and cost-of-service the exception.**

Once the benchmark rates have been set, the Commission has adopted price cap regulation to "govern future rate changes."[44] Price cap regulation meets the two principles Dr. Schankerman describes of compensation and incentive for efficiency. To insure that the efficiency incentives are realized, Dr. Schankerman strongly recommends that cost-of-service as a backstop be applied sparingly. He suggests that any cable operator seeking to utilize the backstop be permitted to trigger it only when a cable system's rate of return falls below a specified level.[45]

Price cap and cost-of-service share the same regulatory compensation principle. The basic compensation premise of rate regulation is to just allow recovery of the costs of providing service inclusive of a normal rate of return on capital. In other words the output prices are controlled by regulation, to generate revenues to just equal the cost of inputs used. The cost level itself reflects the firm's attained productivity. The relationship can be stated in terms of change over time. That is, the change in the

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[43] *Id* at 4.

[44] Rate Regulation Order at paragraph 187.

[45] In keeping with the intent of the price caps mechanism to provide cable operators with efficiency incentives, this trigger rate of return should be set at the bottom of the range determined by the Commission to be the allowed rate of return. Dr. Schankerman further proposes that to simplify administrative proceedings, the Commission should set only a single uniform rate of return as the trigger for all cable operators. Attachment at 5.

output price should equal the change in the cost of inputs and gains in the firm's Total Factor Productivity ("TFP").

This is the basic specification of the price cap, the change in output prices is constrained by the growth in input prices less TFP gains. However, if the Commission uses the firm's own input price change and own TFP growth the price cap formula results in nothing but cost plus regulation.[46] In order for price cap regulation to improve on the outcome of cost-of-service regulation efficiency incentives must be introduced. The incentives in price cap regulation are introduced with external yardsticks of input price change and TFP growth.[47]

The use of an external input price yardstick or target in the price cap requires a composite, aggregate measure of input price change, but there is no such economy-wide measure available. The price cap can use a composite output price index such as the GNPPI which must be adjusted for the economy-wide average growth in TFP. The adjustment for economy-wide TFP growth is necessary because definitionally the change in aggregate output prices is equal to the change in aggregate input prices less aggregate growth in TFP.[48]

The selection of the second external yardstick, the productivity target, is equally critical to meeting another goal, a regulatory scheme that introduces incentives that approach the result of the competitive marketplace. Congress' and the Commission's

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[46] Attachment at 3.

[47] *Id.* at 3, 4. The Commission asks for comment on using a partial productivity measure to set the x-factor adjustment. NPRM at paragraph 84. It is the total factor productivity that is relevant. Dr. Schankerman notes "It is entirely wrong to use any measure of partial productivity (e.g., labor productivity) to set the x-factor. All such measures are incompatible with the economic foundations of the price cap and fail to satisfy the basic compensation principle. . . ." Attachment at 19. "This [partial productivity] approach definitely should be rejected." *Id.* at 18 n.29.

[48] *Id.* at 9.

preference for competition is a given. But, without the inclusion of an external productivity target that goal cannot be met. A competitive market pressures all firms to behave efficiently to extract the maximum productivity gains. As the Commission has noted, a price cap that only adjusts for productivity of the monopoly firm will not encourage efficiency.[49] Dr. Schankerman demonstrates the need for an externally derived productivity target if the efficiency principle is to be satisfied.[50] As Dr. Schankerman states, "It is precisely the decoupling of monopoly cable rates from monopoly cable costs that generates incentives for efficient behavior."[51]

In short, the price cap for cable systems must not only adjust for changes in prices, it must also adjust for two expected productivity gains, the average economy-wide TFP growth and the growth in TFP imposed by the chosen yardstick. The difference between the economy-wide TFP and the target TFP is called the x-factor.[52] The Commission's provisionally adopted cap that only adjusts cable prices by the change in GNPPI will not result in prices that fulfill the Commission's statutory mandate unless it accounts for the difference in the productivity growth. While, at least theoretically, the lack of a productivity adjustment could result in a price cap that is either too low (resulting in confiscation) or too high (resulting in unreasonable rates), it is more likely that the cap will be too high.

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49 In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Further Notice of Proposed Rulemaking, CC Docket No. 87-313, 3 FCC Rcd 3195, 3262 (1988).

50 Attachment at 3.

51 *Id.* at 6.

52 Dr. Schankerman points out that given the high technology nature of the CATV industry, the Commission should expect that the TFP of the cable industry is greater than that of the general economy. *Id.* at 19-20.

Success of the price cap scheme requires that the Commission ascertain the x-factor's correct size. In the LEC price cap proceeding, the x-factor was established based on the industry's historical TFP growth. As the Commission notes, the record here contains no cable industry specific TFP estimates. GTE has performed a review of the economics literature and did not uncover any published TFP study of the cable industry.[53] As the experience of the LEC-AT&T price cap proceeding demonstrates, even when there is a history of scholarly TFP studies, the selection of the best estimate is fraught with contention.[54] With a complete absence of an existing estimate, we can predict with certainty that the process to adoption of a measure for the cable price cap will be lengthy. However, the Commission's price cap specification using GNPPI minus the x-factor is "not the best approach to solving the "yardstick" problem for cable regulation."[55]

Dr. Schankerman offers a unique solution to the dilemma facing the Commission, a price cap formula that includes both a productivity growth yardstick and an input price inflation yardstick that capture the power of the competitive marketplace. This ensures prices are reasonable, encourages efficiency and new investment, and provides a reasonable opportunity to recover costs. Yet, his recommended formulation is extremely easy to implement because it relies only on the change in the output prices of competitive cable systems. As shown, the Commission's specification using GNPPI,

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[53] As explained by Dr. Schankerman, the relevant productivity measure is TFP. The use of partial measure of productivity, e.g., labor, is totally inconsistent with the underlying economics. *Id.* at 18.

[54] The Price Cap Order proceedings had over 50 commenters, almost all of whom dealt with the issue of the x-factor. In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, CC Docket No. 87-313, 5 FCC Rcd 6786, 6862-6866 (1990) ("Price Caps Order").

[55] Attachment at 7.

an indirect measure of input price change, requires establishing the difference in the TFP of the economy and the industry (i.e., x-factor). Dr. Schankerman's proposal solves both of these problems and insures that the regulated cable systems have the same incentives to cut cost and improve efficiency as are present in the competitive marketplace. These incentives are determined in such a manner that consumers' cable rates will rise no more than if their cable prices were subject to direct competition.

The price cap would use both competitive cable productivity growth and competitive cable input price change. However, it can be simplified to use only the change in competitive cable output prices because they are by definition equal.[56] Very simply, the competitive price cap would constrain the change in prices of regulated cable systems by the change in prices of competitive cable systems. Dr. Schankerman begins with the basic price cap specification, derives his specification mathematically and discusses its theoretical underpinnings. He clearly demonstrates that the use of competitive price change is economically sound and entirely consistent with the stated policy. As he says, "This proposed price cap is derived from the same economic principles as the other versions but is far simpler and more direct."[57] He shows that "[t]he only information the Commission needs to implement the price cap are the prices for *competitive* cable systems."[58]

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[56] *Id.* at 11. For competitive systems, output price change is equal to the change in their input prices and growth in their TFP.

[57] *Id.* at 11, 12.

[58] *Id.* at 19. With the use of the competitive price model there is no need to adjust externally for programming cost changes since the change in competitive output prices will "already reflect programming costs for competitive cable systems, and, similarly, the rate of change of output prices will capture changes in programming costs. [Thus, there is no] need for special treatment of programming costs for regulated monopoly systems." *Id.*

### C. If the Commission adopts a price cap using GNPPI, it must include a suitable x-factor.

An advantage of a price cap based on price changes of competitive cable systems is that it does not require an x-factor productivity offset. However, if the Commission does not adopt the competitive price cap, it must adjust its price cap model to include an x-factor that is greater than zero. Using an x-factor equal to zero is simply wrong.

Given that a price cap using GNPPI must have a productivity offset, common sense would lead to the conclusion that TFP growth of the cable industry is not equal to that of the economy at large.[59] The cable industry has introduced high-technology using fiber optics and computerized components which should be reflected in higher than average productivity gains. Without actual credible studies of cable TFP growth, the Commission should rely on TFP growth of a similar industry. Dr. Schankerman believes "the most defensible approach at this stage is to use the TFP performance of local exchange carriers as the yardstick for monopoly cable operators."[60] The Commission should use the LEC x-factor, currently 3.3 percent, pending availability and examination of cable TFP studies.

The Commission has incorrectly posited that the inclusion of scale aspects in the benchmark would address TFP gains due to scale economies. This fails to recognize that the productivity offset must include movements both along the unit cost curve

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59 The argument that higher than average programming cost increases is indicative of lower than average TFP growth cannot be accepted. Growth in programming cost "may well have contributed to faster rather than slower TFP growth for the cable industry . . ." because the growth in cost was associated with a growth in output. *Id.* at 22.

60 *Id.* at 20.

(scale economies) and downward shifts of the curve itself (technological gains).[61] Further, the benchmark relates only to the initial level of TFP (unit cost) that is a point on the cost curve and does not represent movement. Therefore, the benchmark procedure itself provides no support for setting a zero productivity offset.[62]

In summary: The competitive price cap formula proposed by GTE embodies the Congressional directive to rely on the competitive market standard to the maximum extent feasible. It eliminates the need to determine a productivity offset for the cable industry, meets the objective of regulatory simplification, and can be easily implemented. If the Commission retains its provisional price cap the x-factor should be equal to the LEC x-factor, which is currently 3.3 percent, until hard evidence on cable TFP is available and evaluated.

## III. Individual Cost-of-service Elements Should be Designed for the Price Cap Model.

While GTE urges the Commission to rely on the benchmark/price cap model, cost-of-service elements must be identified to define cost-of-service. GTE supports the Commission's tentative conclusions that original cost should be used as the starting point for inclusion of plant in service in rate base,[63] and recommends that acquisition costs in excess of original cost not be permitted for acquisitions prior to October 1992 to the extent such costs are associated with monopoly rents. GTE also concurs in the inclusion of plant specific costs, plant non-specific costs, customer operations, and corporate operations in the determination of cost-of-service.[64] GTE comments

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[61] *Id.*

[62] *Id.* at 19, 20.

[63] NPRM at paragraph 35.

[64] *Id.* at paragraph 24.